The new public procurement rules specific for the defence industry are expected to pave the way for more competition in the European defence market to the benefit of defence industry and security providers.

Many Member States find that existing EC public procurement rules are unfit for defence contracts considering the sensible and complex character and contracts within the sector are often awarded on the basis of national rules, differing within the EU in terms of publication, procedures and award criteria.

In order to create more consistency and transparency, the European Commission has put forward a proposal for a new directive concerning the coordination of procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security (hereinafter the “Directive”) in December 2007. The proposal for the Directive has been adopted by the European Parliament and is expected to be formally adopted by the Council in the very near future.

The general objective of the Directive is to establish an open and competitive European defence market and the Directive is expected to improve cross-border competition and lead to an increase in public procurement within the defence sector over the coming years.

The Directive introduces a range of new provisions of particular interest to companies in the defence and security industry which will be reviewed below. Among other things the Directive provides for new provisions on the requirements that contracting authorities may set in relation to the handling of sensitive information.

Other new initiatives are the contracting authorities’ right to require security of supply and the possibility to use the negotiated procedure as the standard procedure for procurements.

The Directive is part of a European "defence package", which also includes a directive on intra-community defence transfer. The purpose of the latter directive is to streamline existing national licensing procedures and improve conditions for Small and Medium Sized Enterprises (SMEs) that participate in armament development and production.

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The current legal framework

Public contracts awarded in the area of defence and security have until now fallen within the scope of Directive 2004/18/EC (the "Public Procurement Directive").

However, Member States can exempt defence and security contracts from public procurement rules if this is necessary for the protection of their essential security interests. The legal basis for this is Article 296 EC of the Treaty establishing the European Community and Article 14 of the Public Procurement Directive.

Pursuant to Article 296 (1) (a) EC no Member State shall be obliged to supply information if the Member State considers that disclosure will be contrary to the essential interests of its security. This provision covers procurement of both military and non-military equipment and aims at protecting information which Member States cannot disclose without undermining their essential security interests.

The scope of Article 296 (1) (b) EC is limited to procurement of equipment designed, developed and produced for specific military purposes. Member States can only derogate from the public procurement rules with reference to Article 296 (1) (b) EC when:

- the derogation concerns the production of or trade in arms, munitions and war material,
- the derogation is necessary for the protection of essential interests of the Member State’s security, and
- the derogation does not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.

Pursuant to Article 14 of the Public Procurement Directive, public procurement rules do not apply to public contracts when:

- they are declared to be secret,
- when their performance must be accompanied by special security measures in accordance with the laws, regulations or administrative provisions of the concerned Member State, or
- when the protection of the essential interests of that Member State so requires.

In practice, many Member States have systematically invoked Article 296 EC or Article 14 of the Public Procurement Directive in order to exclude military procurement and sensitive security procurement from the scope of Community law. As a result, contracts in this area have often been awarded on the basis of national rules and procedures, which differ significantly in terms of publication, procedures and award criteria.

It is generally recognised that Member States have a broad degree of discretion in deciding how to protect their essential security interests as the concept of ‘essential

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6 The list is specified in Council Decision 255/58 of 15 April 1958. The list is considered sufficiently generic to include recent and future developments although it is important to note, that the list includes only equipment which is of purely military nature and purpose.
interests of security’ is not defined neither in Community Law nor in the case law of the Court of Justice.

However, the Member States’ decisions are subject to the judicial review of the Court of Justice and the Court of Justice has consistently ruled that any derogation from Community rules must be limited to exceptional and clearly defined cases.\(^8\)

In *Commission v. Italy*,\(^9\) the Italian government considered that a purchase of helicopters intended for civilian use (police and fire services) required special security measures and exempted the purchase from the usual requirement of an open tender procedure. In its judgement, the Court repeated that any derogations from public procurement rules must be interpreted strictly and found that Italy was obliged to comply with the rules governing the award of public contracts. The Court also held that an obligation of confidentiality could be imposed in an open tender procedure, such as the competitive dialogue, and Italy had not demonstrated why confidentiality could not be maintained under such procedures.

It also clearly follows from established case law that the burden of proof lies with the Member State. Thus, in *Commission v. Spain*,\(^10\) the Court stated that ”[…] it is for the Member State which seeks to rely on [Article 296 EC] to furnish evidence that the exemptions in question do not go beyond the limits of such [clearly defined] cases […]” and to demonstrate ”[…] that the exemptions […] are necessary for the protection of the essential interests of its security.”.

In 2006, the Commission issued an Interpretative communication on the application of Article 296 EC\(^11\) as part of the initiative towards establishing a European Defence Equipment Market. The Interpretative communication also emphasises that Member States do not have absolute freedom in their decision to exempt the procurement of defence related contracts from the public procurement rules. Furthermore, it follows that the Commission is of the view that for each defence contract in question, contracting authorities should assess whether an exemption from Community rules is justified.

### The new defence procurement directive

The new Directive is largely based on the design and rationale of the Public Procurement Directive but has at the same time been tailored to meet the special requirements in relation to defence and sensitive security contracts.

Member States will still have the possibility to invoke Article 296 EC to exempt defence and sensitive security contracts from public procurement rules. However as a result of the Directive Member States should in most cases be able to apply the procedures in the Directive without running any security risks.

The Directive itself explicitly provides in Article 13 for the possibility to exclude certain contracts. Such contracts include among others:

- contracts which would oblige a Member State to supply information the disclosure of which it considers contrary to the essential interests of its security;
- contracts for the purpose of intelligence activities; and

\(^8\) Case 222/84 Johnston and C-328/92 Commission v. Spain.
\(^9\) Case C-157/06, Commission v. Italy, par. 25-27.
\(^10\) Case 414/97 Commission v Spain, par. 22.
contracts awarded by a government to another government.

Whether a contract falls within the Directive or can be exempted according to Article 296 EC must be assessed on a case-by-case basis. However, since one of the objectives of the Directive is to limit the use of Article 296 EC to truly exceptional cases, the Commission has in line herewith declared, that Member States may derogate from the Directive only in cases where it is not sufficient to safeguard Member States essential security interests.\(^{12}\)

The Commission has furthermore announced that it will closely follow the transposition of the Directive into national law and launch infringement procedures against Member States that fails to implement the Directive as well as in individual cases of misapplication of the new rules.

**Applicable rules and procedures after implementation of the Directive**

**Procurement of military equipment**

- **Art 296 TEC:** The exemption only applies in truly exceptional cases and only if the contracting authority can prove on a case-by-case basis that an exemption is necessary due to the protection of their essential security interests.

- **Article 296 TEC does not apply:**
  - Procurement of military equipment and particularly sensitive security equipment shall follow the procedures in the new Directive provided that the applicable thresholds are met:
    - the negotiated procedure with prior publication of a contract notice can be used as the standard procedure without the need for justification (flexibility).
    - specific provisions on security of information ensures that sensitive or confidential information remains protected.
  - Special clauses allow contracting authorities to address issues in relation to security of supply.

**Procurement of non-military equipment**

- **Directive 2004/18/EC applies in relation to the purchase of non-military equipment and services if the applicable thresholds are exceeded.**

**Article 296 TEC applies:**

- National regulation and procedures apply to procurement of military equipment subject to the Treaty principles of:
  - non-discrimination
  - equal treatment
  - transparency, and
  - proportionality

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12 Press release from the Commission 5 December 2007, MEMO/07/547.
The scope and impact of the Directive

The Directive will apply only to particular contracts in the field of security and defence.

This includes contracts concerning the procurement of military equipment, i.e. arms, munitions and war material as mentioned in the Common Military list of the EU.\(^\text{13}\) The list is from 1958, but should be interpreted in the light of the evolving current technical possibilities and procurement methods.\(^\text{14}\)

The Directive also covers parts, components and/or subassemblies of military and sensitive equipment as well as works, supplies and services directly related to the mentioned military and sensitive equipment.

In the specific field of non-military security, the Directive will apply to procurements which are equally sensitive as defence procurements. This can be the case particularly in areas where military and non-military forces cooperate to fulfil the same missions and/or where the purpose of the procurement is to protect the security of the European Union and/or its Member States on their own territory or beyond it against serious threats from non-military and/or non-governmental actors. This may involve, for example, border protection, police activities and crisis management missions.\(^\text{15}\)

The Directive will only apply to contracts above a certain financial threshold. As the Commission wishes to increase opportunities for Small and Medium sized Enterprises the threshold has been fixed at the current level under the Public Procurement Directive.

The Directive is adapted to the specificities of defence allowing Member States to protect their security interests during the procurement process without violating their obligation to refer to Article 296 EC only in exceptional cases.

Of particular interest to companies within the defence and security sector, the Directive introduces the possibility to use the negotiated procedure as the standard procedure and the Directive furthermore introduces new provisions concerning contracting authorities requirements in relation to the handling of sensitive information and security of supply that will be discussed in more detail below.

**Procurement procedures**

It is recognised that contracts awarded in the field of defence and security often are technically complex and that there is need for more flexibility in relation to such contracts.

Accordingly, the contracting authorities may under the Directive use the negotiated procedure with prior publication of a contract notice as the standard procedure.

Contracting authorities may also choose to use the restricted procedure and in the case of particular complex contracts competitive dialogue.\(^\text{16}\) The open procedure, however, is not available for contracting authorities under the Directive as this procedure was considered to be inappropriate in the light of the confidentiality and the security of information that are attached to contracts within this sector.

\(^{13}\) Council Decision of 15 April 1958.

\(^{14}\) Cf. recital 10 of the new directive.

\(^{15}\) Cf. recital 11 of the new directive.

\(^{16}\) Cf. Article 25 and Article 27.
Under exceptional circumstances contracting authorities are also allowed to use the negotiated procedure **without** prior publication of a contract notice. However, the use of this procedure must be justified with reference to one of the grounds mentioned in the Directive. These grounds are slightly different from the grounds mentioned in the Public Procurement Directive and include, for example, urgency as a result of a crisis or armed conflict and research and development.

Similar to the Public Procurement Directive, technical reasons can also justify the use of the negotiated procedure without prior publication of a contract notice. Interestingly, the Directive emphasises that consideration should be given to the fact that defence and security equipment is often technically complex and that incompatibility or disproportionate technical difficulties in operation and maintenance could justify the use of the negotiated procedure without prior publication of a contract notice. This would seem to suggest that the scope for this procedure may be wider under the Directive than under the Public Procurement Directive.

The possibility to use the negotiated procedure will undoubtedly provide contracting authorities with more flexibility and accommodate the specific security requirements needed in the field of defence and security contracts. For companies within the defence sector this is likely to be good news since more contracts are likely to be tendered for in the years to come. On the other hand, there is a risk that the use of the negotiated procedure will lead to less transparency for companies involved compared to an open or restricted procedure under the Public Procurement Directive.

**Subcontracting**

Contracting authorities may require contractors to sub-contract. Pursuant to Article 21 (4) of the Directive Member States may provide that the contracting authority may ask or may be required to ask the successful tenderer to subcontract a share of the contract to third parties.

The contracting authority that imposes such subcontracting shall provide a range comprising of a minimum and maximum percentage that are to be subcontracted. The maximum percentage may not exceed 30% of the value of the contract. The range shall be proportionate to the object and value of the contract and the nature of the industry sector involved, including the level of competition in that market and the relevant technical capabilities of the industrial base.

Pursuant to the Directive, potential subcontractors should not be discriminated against on the grounds of nationality and depending on the value of the contract, the primary contractor may be required to tender or at least organise a transparent and non-discriminatory competition when awarding subcontracts to third parties.

For companies within the defence sector, this initiative represents an even greater opportunity to be involved in contracts in the defence sector as companies may participate on both contracting- and subcontracting level.

**Security of supply**

Another new initiative under the Directive is that Member States can specify requirements in relation to security of supply. Thus, contracting authorities may for example require tenderers to submit documentation that confirms that their national
governments are not planning to impose bans on the transfer (through for example export controls rules) of the defence related products and services.

Article 23 (a) of the Directive states that contracting authorities may require “certification or documentation demonstrating to the satisfaction of the contracting authority/entity that the tenderer will be able to honour its obligations regarding the export, transfer and transit of goods associated with the contract, including any supporting documentation received from the Member State(s) concerned.”.

For Danish companies it is possible to obtain a pre-approval from the Ministry of Justice in terms of defence material or from the Danish Enterprise and Construction Authority in terms of dual-use material, stating that the products/services in question can be exported without restrictions. It is important to note that companies immediately before the actual export under the current system are required to obtain final approval in order to be able to export the products or services. Due care should therefore be taken in relation to how this is described in the tender offer.

The recently adopted Directive on intra-community defence transfers is likely to replace the system of individual licences with a system of individual, global and general licences. This will imply that the current use of individual licences will become the exception rather than the rule since individual licences should be used only in certain cases.

**Security of information**

When contracts involve, require and/or contain classified information contracting authorities are required to specify in the contract the documentation measures and requirements needed to ensure the security of such information at the requisite level.

To this end, contracting authorities may require a commitment from tenderers and sub-contractors already selected to appropriately safeguard the confidentiality of all classified information in their possession or coming to their notice throughout the duration of the contract. Furthermore, tenderers may be required to provide proof of sub-contractors’ capabilities to deal with sensitive information.

Tenderers may also be required to provide a licence for the production of spare parts, components, specific fittings and specific tests for equipment. Tenderers will need to be aware of this potential requirement when bidding for defence contracts under the Directive, as they may be required to disclose designs, know-how and instructions.

**Framework agreements**

According to Article 29 (2) of the Directive the use of framework agreements running for up to seven years is permitted as opposed to four years under the Public Procurement Directive. This is useful for example in the case of defence material which remains in service for many years.

**Remedies**

The remedies, available to unsuccessful tenderers are the same as in the Public Procurement Directive and include interim orders and damages. The possibility for

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20 Please see further below.
21 Individual licenses should be used only if necessary in the protection of national security interests of a member state, or if necessary to comply with international requirements or commitments, or in cases where it is a matter of only one individual transfer.
unsuccessful tenderers to have a concluded contract set aside that should have been advertised also applies.\textsuperscript{23}

The requirement of a 10 day stand-still period also applies and this will in the same way as under the Public Procurement Directive allow unsuccessful tenderers to challenge the contracting authority’s decision.\textsuperscript{24}

Offset agreements

The Directive does not specifically address the situation where contracting authorities attach certain conditions to a contract in order to offset the fact that the contract is awarded to a foreign contractor. The reason why the Commission has not addressed the issue is probably due to its legal controversy. Member States’ use of offsets will therefore continue even though their legality in relation to the general EC treaty rules is considered questionable.

Indirect non-military offset agreements are generally not covered by Article 296 EC, as the provision only covers dual-use equipment if the application of EC procurement rules oblige the Member State to disclose information prejudicial to its essential security interests. This means that offset agreements in general cannot be exempted from complying with EC procurement rules even if they are related to a defence procurement contract that is exempted on the basis of Article 296 EC.

Moreover, the Commission recalls in its Interpretative communication that Member States must make sure that offset agreements do not adversely affect competition on markets for non-military products.

Directive on intra-EU transfers of defence products

The Directive is part of the defence package which also includes a Directive on intra-EU transfers of defence products and a communication with recommendations for fostering the competitiveness of the sector.

Today, many Member States require national licenses for each crossing of an internal or external border. In order to re-establish the legitimate flow of defence products and give access to suppliers and subcontractors in other Member States, the Commission has adopted a directive simplifying terms and conditions of transfers of defence-related products within the Community replacing the national licence systems with a system of individual, global and general licences in order to facilitate transfers and transits within the EU. As above mentioned, this will imply that the current use of individual licences will become the exception rather than the rule since individual licences should be used only in certain cases.

Global licences are licences for which a company can apply for the purpose of one or more transfers of one or more products to one or more destinations.\textsuperscript{25} General licences are issued by the government and are valid for every company within the territory of the authorised government.

\textsuperscript{23} Cf. Article 56. The Directive leaves some scope for the implementation of the remedies mentioned in Article 56 and it remains to be seen how the position will be under the Danish law.

\textsuperscript{24} Cf. Article 57.

\textsuperscript{25} A global licence is valid for at least three years and for an unlimited number of transfers of particular production categories to particular buyers or a particular category of buyers during the licence period.
The Directive on intra-community defence transfers leaves much discretion to the Member States concerning the implementation of the licensing system and it remains to be seen how effective the new system will become in practice.

Summary

In general, the Directive has the potential to bring arms, munitions and war material as well as sensitive security equipment into the single market. Coordinating national procedures, the Directive will contribute to reduce the current diverse procurement rules in the defence sector.

It will make it easier for contracting authorities to use EC rules in relation to procurement of defence and security goods as the Directive provides more flexibility in relation to both the choice of procedures and the safeguarding of security of supply and security of information. On the other hand, the introduction of the new Directive will most likely also make it more difficult for contracting authorities to justify possible exemptions from the rules in the future.

For companies in the defence and security industry the new Directive means that there will most likely be an increase in invitations to tender in the fields of defence and security. It will also mean that companies will be required to cope with new demands and requirements concerning for example their capability to handle sensitive information and guarantee security of supply.

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